INTERNATIONAL TAX CENTER
ITC
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Leiden 1 October 2013

Joseph L. Andrus
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Centre for Tax Policy and Administration

sent via email to: TransferPricing@OECD.org

Dear Mr. Andrus:

With this letter the International Tax Center Leiden respectfully submits comments to the *Revised Discussion Draft on Transfer Pricing Aspects of Intangibles* ("the draft").

Proposed Amendments to Chapter I - III of the Transfer Pricing Guidelines

Section D.6. Location savings and other local market features

We believe this section provides valuable input especially in clarifying what we believe are issues to be addressed in the comparability analysis and in particular related to one of the comparability factors already used by the current version of OECD Guidelines: Economic Circumstances.

One remark in this respect is that the emphasis in the draft is placed on "geographic markets", whereas we are of the view that the geographic dimension is just one of the relevant dimensions of economic circumstances and markets, especially today and especially in some sectors, are not necessarily defined by geographical boundaries. To this extent, it may be opportune to define market as the combination of supply and demand, where relevant dimensions are a product / service offering, the structure of the supply side and the structure of the demand side. A restriction to geographical boundaries may be interpreted too restrictively thus potentially leading to the rejection of relevant comparables.

Section D.8. MNE Group Synergies

The discussion on Group Synergies and Dis-Synergies is a particularly important one. Although the draft in our view provides valuable guidance especially in relation to some of the issues alluded to under paragraph 1.10 of the current version of the OECD Guidelines, concerns remain on the following aspects:

Measuring synergies is a particularly daunting undertaking. Equally complex is the approach to determining an arm's length allocation of synergies between group members. With the exception of clear examples (such as the ones in paragraphs 21, 24 through 33 of the draft), synergies and dis-synergies are often intimately connected with the specific business model used by a particular MNE (e.g., strategy, corporate culture, public relations, even issues like luck play a role). Isolating the synergistic effects is to say the least in most of the cases impractical and bound to lead to diverging views.

The impact of synergies may be in fact not separable from other constituents of the profitability of a particular MNE.

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The fact that "specific concerted group actions" (cfr. paragraph 19) is indicated as the relevant yardstick may help in partially clarifying, but in general terms it still remains an area of enormous complexity as already indicated under the aforementioned paragraph 1.10.

We believe that, in that respect, the term "deliberate concerted action" may still be ambiguous. We put forward a very simple example:

Imagine a very large company "A" acquires a smaller "B". The smaller company, "B", because it becomes member of a group gets better buying prices for the raw materials. The group does not need to do anything as such: the suppliers start delivering to "B" at the same prices agreed with "A". In this case, apparently "B" does not need to pay anything to "A" for the savings achieved.

In a different case. Large company "a" acquires smaller "b". The supply agreement between suppliers and "a" says that company "a" needs to notify in writing if any new companies are acquired and would use the lower prices. In this case apparently "b" needs to pay something to "a" for the savings achieved because there has been a "deliberate concerted action", however in essence both examples are the same, only company "a" had a legal requirement to notify supplier whereas company A did not.

Further, by moving the discussion about synergies from Chapter 6, Intangibles, to Chapter 1 all intercompany transactions, not only intangibles, will be affected by these new comparability factors. When using the TNMM to benchmark a distributor or a manufacturer, do we need to do adjustments to the interquartile range or median to take into account synergies or work force in place? How do we do that? Aren't we applying more strict search criteria to intangibles and loans that to other goods and services?

We believe that in this respect the guidance should provide affirmative support to situations where general synergistic effects that stem from the essence of the business model not necessarily have to be separately identified since they are immanent in the way the MNE operates and can be assumed to have been allocated at arm's length. Paragraph 63 of the draft appears to point in that direction. To be consistent with Chapter 7 that does not allow to charge shareholders costs intercompany and that requires that these costs stay at the shareholder level, also synergy benefits that cannot be attributed to a specific party would be for the shareholder.

Proposed modification to paragraph 2.9 of the Guidelines

We are of the view that the text proposed in paragraph 34 is rather restrictive, especially in view of the fact that the draft is allowing much more latitude to other methods based on discounted cash flow analysis and income-based approaches for transfer pricing analyses related to intangibles.

We do not therefore understand what the concerns are that such a restrictive language is trying to address. The impression is that from a "most appropriate method rule", the language in the proposed paragraph 2.9 switches to a "best method rule" imposing too high a burden in documenting what can be most evidently self explanatory especially in cases dealing with pricing intangible property.

Chapter VI - Special Considerations for Intangibles

Section A.3. Categories of intangibles

Paragraphs 49 and 50 still propose a distinction between marketing and trade intangibles as in the current version of the OECD Guidelines. We are of the view that this distinction is no longer necessary and at times may even be confusing. We therefore suggest eliminating the distinction, especially considering the very purpose of the draft, which is clarifying on how to identify intangibles by broadening the approach to definition.

Section A.4. Illustrations

Par 62 reads that "Accounting and business valuation measures of goodwill and ongoing concern do not, as a general rule, correspond to the arm's length price of transferred goodwill or ongoing concern value in a transfer pricing analysis". However par 165 reads that "In some situations, intangibles acquired by an MNE group from independent enterprises are transferred to a member of the MNE group in controlled transactions immediately following the acquisition. In such case the price paid for the acquired intangibles will often (after any necessary adjustments for acquired assets not re-transferred) represent a useful comparable for determining an arm's length price for the controlled transaction under a CUP method."

Aren't these two sentences in contradiction? When a company acquires a business from a third party they pay a price for the whole business. The break down of the prices into different assets is something that may be done before acquisition at a very high level and that may need to be revisited completely based on the final price agreed between the parties to the transaction and as more information about the target becomes available. The only asset allocation done after the acquisition is the Purchase Price Allocation ("PPA"), which is available 3 to 6 months after the acquisition. Buyer and seller *do not need to agree* in the allocation of the purchase price to assets, and in fact they often don't agree. The allocation in the PPA is only an allocation for accounting purposes that Par 62 says, and we agree with, does not need to be used for transfer pricing purposes, although it can be used as a starting point.

Paragraphs 62, 165 and 173 refer to the same situation but arrive to what we believe are different conclusions. We feel the language on these paragraphs should be further worked upon and clarified. There is already a lot of disputes on going with tax authorities around the world about the use of PPA to determine transfer prices and about the use of the goodwill value on this PPA when calculating exit payments. We refer to our presentation to the OECD of last 12-14 November 2012 for more details on the point of goodwill.

As a side note, one of the LLM students from the ITC wrote his thesis on the subject of goodwill this year, summer 2013, although we do not necessarily agree with all the points made in his thesis, we would encourage the OECD to read the paper to see how different countries look at the subject of goodwill in completely different ways leading to a lot of controversy.

Section B. Ownership of Intangibles and Transactions Involving the Development, Enhancement, Maintenance and Protection of Intangibles

Whilst we agree with the framework proposed in paragraph 66, we believe that the emphasis is still too heavy on re-characterization of transactions as currently formulated. We propose inserting a step before step (vi) as follows: "(v) where necessary carry out comparability adjustments in order to improve comparability based on the findings of the comparability analysis."

Section B.2. Functions, assets and risks related to intangibles

Paragraphs 74 to 89 propose an approach to defining ownership of intangibles (or entitlement to intangible-related returns) that can be, in our view, seen as departing from the general approach followed in Chapters I to III and in Chapter IX.

The emphasis of the aforementioned paragraphs is on "functional control", and the language appears to allude to an interpretation of the term "ownership / entitlement" very much following the Authorized OECD Approach on Attribution of Profits to Permanent Establishments.

We believe that in particular paragraphs 79 and 80 propose a view that positions the notion of "functional control" beyond what we believe the original purpose was: i.e. to provide an alternative framework in situations where there is no evidence of comparable situations between unrelated parties.

The point discussed in paragraph 80 is reminiscent (in terms of conclusions: "where the legal owner outsources most or all of such important functions […] the entitlement […] to retain any material portion of the return […] is highly doubtful") of the "crown jewels" example in an early draft of Chapter IX. This "crown jewels" example was finally dropped but it comes back here with other words. We are of the opinion that this language is too judgmental and not in line with the spirit of the OECD Guidelines, if not grounded on the premise of a thoroughly conducted comparability analysis. Further, this is also at odds with the guidance contained in paragraph 158 of the draft.

We submit that the emphasis on "functional control" through own employees without any regard to governance structures in the context of separate legal entities (an not in the context of the application of the "separate entity approach" in an Article 7 (Attribution of Profits to Permanent Establishments) situation), opens the door to enormous freedom for countries to object with one another's position as to what constitute an "important function", what is the minimum number of own employees required, what is the level of competence and authority required and so forth. This again, without specific regard to the role of governance structures that are at the very essence of body corporates.

As to paragraphs 82, 83 and 84, we believe that the position expressed is too restrictive as to the role of capital. We wonder how to reconcile this very restrictive position (reminiscent of the "investor model" under the new US Cost Sharing Regulations) with potentially comparable situations and investment structure in, e.g., venture capital or private equity investments.

Section C. Transactions involving the use or transfer of intangibles

In general we find that the guidance provided in Section C is somehow repetitive and this section could be shortened by reference to Chapters I and III.

As to the guidance proposed under paragraph 109, some of the characteristics of licensing agreements between third parties are not applicable or not relevant in an inter-company context. We have tried for example to establish several times, looking at agreements between third parties, if there is a correlation between the agreement being exclusive or non-exclusive and the profitability of the licensee. There is not a correlation, or at least we have not been able to find, using public information, a sector where there is a clear correlation between the agreement being exclusive or non-exclusive and the profitability of the licensee. There are too many other factors that impact the profitability of the licensee and it is not possible to separate each characteristic of the agreement.

Paragraph 113 discusses the case of intertwined intangibles by proposing an example related to reputational value and trademark. In our view the example does not consider that, if a trademark is appropriately valued and priced, it does already embed the reputational value. As such the example is redundant in our view.

Section D. Supplemental Guidance for Determining Arm's Length Conditions in Cases Involving Intangibles

As a general remark, we feel that paragraph 151 is a prominent one and quite clear on the content and it should be given more relevance by placing it at the very beginning of this section.

The whole section on use of valuation techniques is rather generic and - we feel - does not add anything that cannot already be distilled from best practices in applying these techniques in other fields of valuation (e.g. for investment analysis or capital budgeting purposes etc.).

On assumptions related to taxes, we generally agree with the statement that tax considerations may influence the choices of independent parties when negotiating the transfer of an asset. This is in theory true for both sides of the transaction.

However, tax is just one of many factors that may have an influence in the negotiation dynamics between independent parties and in addition to that, it is not necessarily clear from the economic literature whether tax considerations have an immediate and directly correlated impact on prices.

Further, one should consider the consequences *of all tax attributes of both parties to the transaction* and that is certainly an assumption too many if we consider that unrelated parties would not necessarily have access to that information. When a party is selling an intangible (or tangible) asset to a third party they can have an approximate idea of what the tax cost of selling that intangible asset is for them -we say approximate because in fact the seller does never know the exact tax cost as there are always ambiguities in the law and he needs to make certain assumptions about his own acquisition strategy, even the seller does not know the exact tax cost until a few months after the transaction, or even until the transaction is audited by the tax authorities, which can happen many years later. However, the seller can only speculate about what is the tax strategy of the buyer. The seller will try to estimate what is the tax cost for the buyer, and will try to include that in their price negotiation, however the final impact of this "estimated cost" in the final price agreed can be immaterial or can be very important, to the point of being a deal breaker. It is impossible to replicate the impact of this in an intercompany situation as each buy/sell transaction between third parties is unique in how buyer and seller look at the tax cost.

There are also computational issues that cannot be underestimated, such as the determination of an appropriate pre-tax discount rate. We therefore propose that the valuation of intangibles be done on an after tax basis, just like third parties do, giving consideration only to the potential positive cash flows from e.g. increased deductions - amortization benefits and reduced taxation, which should be allocated based on the overall bargaining position of the respective parties to the transaction.

We would like to request the OECD that the question about the use of cash flows after tax is clear in the main body of Chapter 6, now it is only clear in example 24, as there is a lot of disparity about how tax authorities around the world stand on this point, leading often to double taxation, and to long discussions on the subject.